

EMF-ECBC Response to the European Commission Public Consultation on the Capital Markets Union (CMU) Mid-Term Review 2017

Brussels, 17 March 2017

The European Mortgage Federation-European Covered Bond Council (EMF-ECBC) represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and wide range of interested stakeholders. The ECBC was launched by the European Mortgage Federation (EMF) to promote the interests of covered bond market participants at international level. As of March 2017, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions representing over 95% of covered bonds outstanding, which were worth nearly 2.5 trillion EUR at the end of 2015.

1. Introduction

The EMF-ECBC strongly supports the Capital Markets Union (CMU) initiative and the plan of the European Commission to create deeper and more integrated capital markets in the Member States of the European Union (EU). Our organisation aims at contributing to exploring ways of reducing fragmentation in financial markets, diversifying financing and funding sources, strengthening cross-border capital flows and improving access to finance for businesses, particularly small and medium-sized enterprises (SMEs).

In this relation, the EMF-ECBC welcomes the opportunity to comment on the consultation document regarding the Mid-Term Review of the CMU which was published on 20 January 2017 by the European Commission. Please find below our feedback on Sections 3 and 5 of the consultation.

2. General Comments

The EMF-ECBC strongly believes that an efficient and robust financial sector is a key driver for growth, and that a degree of harmonisation is essential in building a European capital market.

By way of background information, covered bonds play an essential role in ensuring the flow of capital in financing long-term growth and the real economy, which makes this asset class a key finding tool for the European banking industry. They offer key safety features such as a strict legal and supervisory framework, asset segregation, and a cover pool actively managed in order to maintain the quality of the collateral. Most notably, during the recent years of market turmoil, the covered bond asset class confirmed its significant role as a crisis management tool due to its ability to ensure: (i) investors' confidence; (ii) financial stability; and (iii) long-term financing.

In addition, the EMF-ECBC previously expressed its support of the European Commission's proposal for further convergence in European covered bond markets, as outlined in the organisation's response to the Commission's consultative document on covered bonds in the EU from January 2016 (available [here](#)), as it is a prerequisite for a continued regulatory recognition of the instrument's inherent quality features. To reiterate, such convergence should be based on a high-quality principle-based approach and best market practices, while simultaneously taking into account national covered bond market specificities.

Moreover, we express our support of the proposed recommendations for possible harmonisation of covered bond frameworks as outlined in the European Banking Authority's (EBA's) Report from December 2016 and we are looking forward to collaborate with the EU bodies on the matter going forward, as needed.

3. Specific Comments

Section 3: INVESTING FOR LONG-TERM, INFRASTRUCTURE AND SUSTAINABLE INVESTMENT

Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

➤ Energy Efficient Mortgages

For more than two years, the EMF-ECBC has been working on the development of a standardised, pan-European mortgage financing mechanism, according to which EU households are incentivised to improve the energy efficiency (EE) of the EU's housing stock by way of preferential financial conditions linked to the mortgage. The EMF-ECBC initiative is entirely independent from, but complementary to, public funds, tax incentives and utility rebates. **In order to help unlock the potential of the mortgage industry to support the EU in delivering on its energy savings targets, the EMF-ECBC believes that the lower risk of energy efficient mortgages, see below for more detail, should be recognised in the regulatory framework in the form of lower capital requirements for these exposures and that this issue should be considered during the next review of the CRR/CRDIV.**

As background to the initiative, buildings are responsible for 40% of energy consumption & 36% of CO₂ emissions in the EU. 75-90% of the building stock in the EU is predicted to still be standing in 2050 making energy efficient refurbishment a top priority for Europe. By improving the EE of buildings, total EU energy consumption could be reduced by 5%-6% and CO₂ emissions by 5%. The EU has very ambitious energy savings targets for 2020 and 2030, which require €100 billion per year of investment to be met.

With these considerations in mind, the starting point for the energy efficient mortgage initiative was the realisation that: (i) banks, in financing the purchase of homes, could play a game-changing role in supporting the EU's energy savings targets, by bringing EE and energy efficient renovation into the conversation between banks and consumers at a very opportune moment and then financing that renovation, and (ii) by way of the Project, the EMF-ECBC can help to deliver additional synergies in the lending and funding value chain and fill a gap by delivering a new asset class, an energy efficient mortgage, which could be used for the purposes of green bond and green covered bonds issuance, creating a virtuous circle. To the end, the ECBC has begun working on a Green Covered Bond Label which will allow the identification of green/ sustainable covered bonds on the ECBC Covered Bond Label¹ website.

The ultimate success of the Project rests on two assumptions: that improved EE of the property lowers the PD of the borrower (because there is more disposable income in the household) and that improved EE increases the value of the property.

In turn, these two assumptions drive an incentive chain which provides a micro-economic advantage to all stakeholders: borrowers, lenders, investors and SMEs. Of additional relevance to the CMU are the benefits for SMEs and therefore the real economy: the private investments foreseen will provide a flow of

¹ The Covered Bond Label, which is a market-led transparency initiative which has improved and facilitated further convergence of covered bonds best practices. The Covered Bond Label has enhanced significantly the level of transparency of covered bond markets in Europe and around the globe by facilitating and improving the access to information on i) liability, ii) regulation and iii) assets and regulatory compliance in a harmonised way.

capital into the real economy and in doing so support privately held companies, e.g. small and medium-sized enterprises (SMEs), engaged in renovation meanwhile encouraging innovation and stimulating start-ups in the field of energy efficiency. The EMF-ECBC Initiative will thereby support the important efforts of the European Commission to encourage jobs and growth in the EU.

Central to the incentive chain is the business case for lenders to originate energy efficient mortgages. A key element of the EU-funded project will be the substantiation of the correlation between EE and property value, and therefore loss given default, and probability of default. These are two important risk parameters which are used for the calculation of banks' capital requirements. Once this positive correlation is substantiated, as indicated above **the EMF-ECBC believes that the lower risk of energy efficient mortgages should be recognised in the regulatory framework in the form of lower capital requirements for these exposures and that this issue should be considered during the next review of the CRR/CRD.** This would represent a strong incentive for banks to originate these types of mortgages and would significantly boost private financing of energy efficient renovation.

At this stage, it is difficult to quantify the expected investment in EE that would result from the introduction of a standardised, pan-European energy efficient mortgage, however, with a risk-based perspective in mind, according to which the risk profile of the borrower would not be increased, two workable assumptions give a sense of the potential of the Project: firstly, let us assume for purely illustrative purposes that conservatively one third of new lending in the EU will be labelled as "energy efficient" according to parameters to be defined during the course of the EU-funded project; and secondly that for this one third of new lending, lenders will provide on average 8% of extra volume to finance the energy efficient improvement of the mortgaged properties.

Looking at data produced by the EMF-ECBC, over the last 5 years, annual gross lending of a large number of EU Member States averaged around EUR 851 billion². Based on the above mentioned assumptions, 8% over and above the one third of new EE lending would represent investment in EE, amounting therefore to around EUR 23 billion annually, more than one fifth of the amount required by the EU on a yearly basis in order to meet its energy savings targets.

Moreover, the European Secured Note (ESN) (explained below), would furthermore complement the long-term funding toolkit in the EU as it could potentially be used for other types of assets, such as infrastructural loans, and thereby improve infrastructural funding capacity.

Section 5: STRENGTHENING BANKING CAPACITY TO SUPPORT THE WIDER ECONOMY

Are there additional actions that can contribute to strengthening banking capacity to support the wider economy? Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

➤ The Covered Bond Label

In addition to its work on EE mortgages, the EMF-ECBC has since 2012 established the [Covered Bond Label](#). This market-led initiative enhanced significantly the level of transparency in the Covered Bond market. This is done standardising the information provided by issuers on their cover pools and cover assets, through the Covered Bond Label website and the [Harmonised Transparency Template \(HTT\)](#). The Harmonised Transparency Template (HTT) is the worldwide standardised, Excel-based form that issuers who have been granted the Covered Bond Label use to disclose information on their covered bond programs. Definitions and format of the disclosed information are standardised to increase comparability

² Hypostat 2016: <http://www.hypo.org/Content/default.asp?PageID=524>.

and transparency between issuers and between jurisdictions. Standardisation facilitates investors' due diligence, enhancing overall transparency in the Covered Bonds market. The HTT, designed to be fully compliant with art 129(7) CRR transparency requirements, undergoes constant review, stirred by the Covered Bond Label & Advisory committees, so to be always up-to-date with regulatory and market requirements. Additional country-specific information on the covered bond programs can be found in the National Transparency Templates often included in the HTT.

The EMF-ECBC firmly believes that market-led initiatives such as the Covered Bond Label are an effective mechanism to achieve the goal of harmonisation by assisting further convergence, thus improving the integration of covered bond markets. Furthermore, market-led initiatives raise awareness amongst market participants, policy makers and competent authorities at national level that such a convergence should be achieved.

The Covered Bond Label has provided a user-friendly harmonised transparency tool, presently used by 87 covered bond issuers on 103 cover pool in 16 jurisdictions. It has increased transparency convergence in the EU covered bond market for the first time since transparency principles were identified in article 52(4) of the UCITS Directive in 1985. Acknowledging the adequacy of the Covered Bond Label to the market and to covered bond issuers across Europe with a degree of regulatory recognition would furthermore help to: (i) avoid the requirement to legislate for grandfathering, which is important considering the IT costs it would impose on issuers to implement transparency standards via law; (ii) ensure that the Covered Bond Label will continue to be able to adapt and react rapidly to address market developments without the requirement for lengthy legislative processes, which is essential given the dynamic nature of transparency within a changing financial landscape; and (iii) increase incentives for more issuers to join the Label initiative and thus ensure further convergence in the European covered bond market.

The recognition of the importance of the Covered Bond Label from regulators is critical for the success of this initiative which, by standardising data disclosure, increases transparency across the entire industry potentially reducing costs across the board and enhancing banks' capacity to fund the real economy.

➤ **European Secured Note (ESN)**

Furthermore, in order to strengthen banks capacity to support the wider economy, we would reiterate our proposal of leveraging on existing best practices replicating them for SME funding. The EMF-ECBC has been working on designing a possible new funding instrument, the European Secured Note, replicating the best practices of covered bonds and securitisations.

One of the critical points for the success of the **ESN project is the design of a supervisory framework targeting specific asset classes such as small and medium-sized enterprise (SME) or infrastructure loans, thus following one of the major strengths of covered bonds**. The envisaged ESN proposal considers long-term financing solutions for these loans which could be financed by using either:

- an on-balance sheet dual recourse instrument using funding techniques derived from those used for covered bonds; or
- an off-balance sheet solution which uses high-quality securitisation techniques that could also offer risk sharing (and capital relief).

In the case of an on-balance sheet ESN the asset pool would have to fulfil specific criteria such as a harmonised definition for SME loans, eligibility criteria for SME loans, appropriate levels of over-collateralisation (OC); and clear pari-passu priority claims of the investor to the issuer's assets in the case of default and insufficiency of the pool to cover the value of the bond.

Due to its similarity with a covered bond it could have the obvious advantage of benefiting from regulatory recognition, thus providing the issuer with an additional tool to fulfill liquidity requirements such as the Liquidity Coverage Requirement (LCR). In fact, the transformation of SME loans into an ESN would improve the regulatory and prudential treatment of such assets, by making the bond UCITS compliant, and therefore exempt from bail-in, and eligible for a number of prudential and regulatory requirements, such as under Solvency II. In this context, two elements are necessary for the ESN to successfully play this role: (i) there must be a robust legal framework around the creation of such an instrument; and (ii) there must be a sufficiently high level of transparency regarding the asset pool.

The off-balance sheet solution, which would, in some respects, have analogies with the securitisation techniques would provide benefits to both the issuer and the investor which would share some risks and be remunerated accordingly. It could offer both funding and some capital relief to the issuer, which would thereby be able to use freed-up capital for additional lending; this would also have the advantage of lowering capital requirements.

More detailed information on the expressed views hereby can be found in the position paper which the ECBC submitted to the European Commission as a response to the Green Paper on Building a Capital Market Union on 12 May 2015 (available [here](#)).

4. Conclusion

We would like to thank the European Commission for taking into account our feedback on the matter and we stand ready to provide further clarification or elaboration on our views, as may be needed.